

# Bogus “Solutions” to the Financial Crisis: The Latest in Junk Economics

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## Marginalist Panaceas to Today’s Structural Problems

It looks like bookstores are about to be swamped this summer and fall by a forest of advice for which publishers gave respectable advances a year ago as the economy was going off the rails. Seeking to minimize the risk of cognitive dissonance, the marketing strategy seems to be to offer advice by well-placed or celebrity insiders on how to recover the kind of free lunch that American pension plans – and popular hopes for easy wealth – have long assumed to be part of the natural law of economic growth, if only it can be better managed. The fantasy people want to buy is that the happy 1981-2007 era of debt-leveraged price gains for real estate, stocks and bonds can be brought back. But the Bubble Economy was so debt-leveraged that it cannot reasonably be restored. This means that publishers have achieved the marketer’s dream of planned obsolescence: Readers a year or so from now will have to buy a new slew of books as they feel hungry again from the lack of intellectual protein.

For the time being we are supposed to be satisfied Wall Street defenses of the Bush-Obama (Paulson-Geithner) attempt to re-inflate the Bubble by a bailout giveaway that has tripled America’s national debt in the hope of getting bank credit (that is, more debt) growing again. The problem is that debt leveraging is what caused the economic collapse. A third of U.S. real estate is now estimated to be in negative equity, with foreclosure rates still rising. So publishers have only a short window of opportunity to sell the current spate of books before people wake up to the fact that attempts to renew the Bubble Economy will make our financial overhead heavier.

In the face of this stultifying financial trend, the book-buying public is being fed appetizers pretending that economic recovery simply requires more “incentives” (a euphemism for special tax breaks for the rich) to encourage more “saving,” as if savings automatically finance new capital investment and hiring rather than what really happens: Money is being lent out to create yet more debt owed by the bottom 90 percent to the economy’s top 10 percent. Publishers evidently believe that the way to attract readers – and certainly to get reviews in the major media – is to propose easy solutions. The theme of most of this year’s Bubble books therefore is how we could have avoided the Bubble “if only...” If only there had been better regulation, for instance.

But to what aim? After blaming Alan Greenspan for playing the role of “useful idiot” by promoting deregulation and blocking prosecution of financial fraud, most writers trot out the approved panaceas: federal regulation of derivatives (or even banning them altogether), a Tobin tax on securities transactions, closure of offshore banking centers and ending their

tax-avoidance stratagems. But no one is going so far as to suggest attacking the root of the financial problem by removing the general tax deductibility of interest that has subsidized debt leveraging, taxing “capital” gains at the same rate as wages and profits, or closing the notorious tax loopholes for the finance, insurance and real estate (FIRE) sectors.

Right-wing publishers are re-warming their articles of faith such as giving more tax incentives to “savers” (another euphemism for more giveaways to the rich) and a re-balanced federal budget to avoid “crowding out” private investment. One of Wall Street’s dreams is to privatize Social Security to create yet another Bubble to feed off of. (Fortunately, such proposals failed during the Republican-controlled Bush administration as a result of taxpayer outrage after the dot.com bubble burst in 2000.)

What is not heard is a call to finance Social Security and Medicare out of the general budget instead of keeping their funding as a special regressive tax on labor and its employers, available for plunder by Congress to finance tax cuts for the upper wealth brackets. Yet how can America achieve competitiveness in global markets with its pre-saving retirement tax (Social Security) and privatized health insurance, debt-leveraged housing costs and related personal and corporate debt overhead? The rest of the world provides much lower-cost housing, health care and related employee costs – or simply keeps labor near subsistence levels. Our lack of affordability is a major problem for continued dreams of a renewed Bubble Economy, yet the international dimension is ignored.

The latest panacea being offered to jump-start the economy is to rebuild America’s depleted infrastructure. Alas, Wall Street plans to do this Tony Blair-style, by public-private partnerships that incorporate enormous flows of interest payments into the price structure while providing underwriting and management fees to Wall Street. Falling employment and property prices have squeezed public finances so that new infrastructure investment will take the form of installing privatized tollbooths over the economy’s most critical access points such as roads and other hitherto public transportation, communications and clean water.

Surprisingly, one does not hear even an echo of calls to restore state and local property taxes to their Progressive Era levels so as to collect the “free lunch” of rising land prices and harness its gains over time as the main fiscal base. This would hold down land prices (and hence, mortgage debt) by preventing rising location values from being capitalized into new mortgage loans against “capital” gains and paid out as interest to the banks. Restoring Progressive Era tax philosophy (and pre-1930 property tax levels) would have the additional advantage of shifting the fiscal burden off income and sales – a policy that would make labor, goods and services more affordable. Instead, most reforms today call for further cutting property taxes to promote more “wealth creation” in the form of higher debt-leveraged property price inflation. Instead of housing prices falling and income and sales taxes being reduced, rising site values merely will be recycled to the banks for ever larger mortgages, not taxed to benefit local government. In this scenario, local governments are forced to shift the fiscal burden onto consumers and business, impoverishing the community.

The new books advocate merely marginal changes to deep structural problems. They include the usual pro forma calls to re-industrialize America, but not to address the financial debt dynamic that has undercut industrial capitalism in this country and abroad. How will these timid “reforms” look in retrospect a decade from now? The Bush-Obama bailout

pretends that banks “too-big-to-fail” only face a liquidity problem, not the growing bad-debt problem we now face along with the economy’s widening inability to pay. The reason why past Bubbles cannot be re-inflated is that they have reached their debt limit, not only domestically, but also the international political limit of global Dollar Hegemony.

What needs to be written about is what the marginalists leave out of account and what academic jargon calls “exogenous” considerations, which turn out to be what economics really is all about: the debt overhead; financial fraud and crime in general (one of the economy’s highest-paying sectors); military spending (a key to the U.S. balance-of-payments deficit and hence to the buildup of central bank dollar reserves throughout the world); the proliferation of unearned income and insider political dealing. These are the core phenomena that “free market” idea strippers have relegated to the “institutionalist” basement of the academic economics curriculum.

For example, the press keeps on parroting the Washington mantra that Asians “save” too much, causing them to lend their money to America. But the “Asians” saving these dollars are the central banks. Individuals and companies save in yuan and yen, not dollars. It is not these domestic savings that China and Japan have placed in U.S. Treasury securities to the tune of \$3 trillion. It is America’s own spending – the trillions of dollars its payments deficit is pumping abroad, in excess of foreign demand for U.S. exports and purchases of U.S. companies, stocks and real estate. This payments deficit is not the result of U.S. consumers maxing out on their credit cards. What is being downplayed is that military spending in most years since the Korean War (1951) that has underlain the U.S. balance-of-payments deficit. Now that foreign countries are starting to push back, this trend cannot continue much longer.

Inasmuch as China’s central bank is now the largest holder of U.S. Government and other dollar securities, it has become the main subsidizer of the U.S. balance-of-payments deficit – and also the domestic U.S. federal budget deficit. Half of the federal budget’s discretionary spending is military in character. This places China in the uncomfortable position of being the largest financier of U.S. military adventurism, including U.S. attempts to encircle China and Russia militarily to block their development as economic rivals during the past fifty years. That is not what China intended, but it is the effect of global dollar hegemony.

Another trend that cannot continue is “the miracle of compound interest.” It is called a “miracle” because it seems too good to be true, and it is – it cannot really go on for long. Heavily leveraged debts go bad in the end, because they accrue interest charges faster than an economy’s ability to pay. Basing national policy on dreams of paying the interest by borrowing money against steadily inflating asset prices has been a nightmare for homebuyers and consumers, as well as for companies targeted by financial raiders who use debt leverage to strip assets for themselves. This policy is now being applied to public infrastructure into the hands of absentee owners, who will themselves buy these assets on credit and build the resulting interest charges into the new service prices they collect, in addition to being allowed to treat these charges as a tax-deductible expense. This is how banking lobbyists have shaped the tax system in a way that steers new absentee investment into debt rather than equity financing.

The irresponsible cheerleaders applauding a Bubble Economy as “wealth creation” (to use one of Alan Greenspan’s favorite phrases) would like us, their audience, to believe that they knew that there was a problem all along, but simply could not restrain the economy’s “irrational exuberance” and “animal spirits.” The idea is to blame the victims – homeowners

forced into debt to afford access to housing, pension-fund savers forced to consign their wage set-asides to money managers at the large Wall Street firms, and companies seeking to stave off corporate raiders by taking “poison pills” in the form of debts large enough to block their being taken over. One looks in vain for an honest acknowledgement of how the financial sector has turned into a Mafia-style gang more akin to post-Soviet kleptocrat insiders than to Schumpeterian innovators.

The cursorily reformist gaggle of post-Bubble tomes assumes that we have reached “the end of history” as far as financial problems are concerned. What is missing is a critique of the big picture – how Wall Street’s collaboration in financializing the public domain has inaugurated a neo-feudal tollbooth economy while privatizing the government itself, headed by the Treasury and Federal Reserve. Left untouched is the story how industrial capitalism has succumbed to an insatiable and unsustainable finance capitalism, whose newest “final stage” seems to be a zero-sum game of casino capitalism based on derivative swaps and kindred hedge fund gambling innovations.

What has been lost are the Progressive Era’s two great reforms. First, minimization of the economy’s free lunch of unearned income (e.g., monopolistic privilege and privatization of the public domain in contrast to one’s own labor and enterprise) by taxing absentee property rent and asset-price (“capital”) gains, keeping natural monopolies in the public domain, and anti-trust regulation. The aim of progressive economic justice was to prevent exploitation – e.g., charging more than the technologically necessary costs of production and reasonable profits warranted. Progressive Era reforms had a fortuitous byproduct: Minimization of the free lunch enabled economies such as the United States to out-compete others that didn’t embrace progressive fiscal and financial policy, creating a Leviathan that has now fallen to its knees.

The second Progressive Era reform was to steer the financial sector so as to fund capital formation. Industrial credit was best achieved in Germany and Central Europe in the decades prior to World War I. But the Allied victory led to the dominance of Anglo-American banking practice based on loans against property or income streams already in place. Because of this, today’s bank credit has become decoupled from capital formation, taking the form mainly of mortgage credit (80%), and loans secured by corporate stock (for mergers, acquisitions and corporate raids) as well as for speculation. The effect is to spur asset-price inflation on credit, in ways that benefit the few at the expense of the economy at large.

The consequences of debt-leveraged asset-price inflation are clearest in the post-Soviet “Baltic syndrome,” to which Britain’s economy is now succumbing. Debts are run up in foreign currency (real estate mortgages, tax-avoidance funds and flight capital), without exports having any prospect of covering their carrying charges as far as the eye can see. The result is a debt trap – chronic austerity for the domestic market, causing lower capital investment and living standards without hope of recovery.

These problems illustrate the extent to which the world economy as a whole has pursued the wrong course since World War I. This long detour has been facilitated by the failure of socialism to provide a viable alternative. Although Russia’s bureaucratic Stalinism got rid of the post-feudal free lunch of land rent, monopoly rent, interest and financial or property-price gains, its bureaucratic overhead overpowered the economy in the end and Russia fell. Ideology aside, the question is whether the Anglo-American brand of finance capitalism will follow suit from its own internal contradictions.

The flaws in the U.S. economy are tragic because they are so intractable, embedded as they are in the very core of post-feudal Western economies. This is what Greek tragedy is all about: A tragic flaw that dooms the hero from the outset. The main flaw embedded in our own economy is rising debt in excess of the ability to pay, which is part of a larger flaw - the financial free lunch that property and financial claims extract in excess of corresponding costs as measured in labor effort and an equitably shared tax burden (the classical theory of economic rent). Like land seizure and insider privatization deals, such wealth increasingly is inherited, stolen or obtained through political corruption. Adding insult to injury, wealth and revenue extracted via today's finance capitalism avoids taxation, thereby receiving an actual fiscal subsidy as compared to tangible industrial investment and operating profit. Yet academics and the popular media treat these core flaws as "exogenous," that is, outside the realm of economic analysis.

Unfortunately for us - and for reformers trying to rescue our post-Bubble economy - the history of economic thought has been suppressed to give the impression that today's stripped-down, largely trivialized junk economics is the apex of Western social history. One would not realize from the present discussion that for the past few centuries a different canon of logic existed. Classical economists distinguished between earned income (wages and profits) and unearned income (land rent, monopoly rent and interest). The effect was to distinguish between wealth earned through capital and enterprise that reflects labor effort, and unearned wealth from appropriation of land and other natural resources, monopoly privileges (including banking and money management) and inflationary asset-price "capital" gains. But even the Progressive Era did not go much beyond seeking to purify industrial capitalism from the carry-overs of feudalism: land rent and monopoly rent stemming from military conquest, and financial exploitation by banks and (in America) Wall Street as the "mother of trusts."

What makes today's Bubble different from previous ones is that instead of being organized by governments as a stratagem to dispose of their public debt by creating or privatizing monopolies to sell off for payment in government bonds, the United States and other nations today are going deeply into debt simply to pay bankers for bad loans. The economy is being sacrificed to reward finance instead of remaining viable by subordinating and channeling finance to promote economic growth via an affordable economy-wide cost structure. Interest-bearing debt weighs down the economy, causing debt deflation by diverting saving into debt payments instead of capital investment. Under this condition "saving" is not the solution to today's economic shrinkage; it is part of the problem. In contrast to the personal hoarding of Keynes's day, the problem is that the financial sector is now using its extractive power as creditor instead of wiping out the economy's bad-debt overhang in the historically normal way, by a wave of bankruptcies.

Today, the financial sector is translating its affluence (at taxpayer expense), into the political power that threatens to pry yet more public infrastructure away from state and local communities and from the public domain at the national level, Thatcher- and Blair-style. It will be sold off to absentee rentier buyers-on-credit to pay off public debt (while cutting taxes on wealth yet further). No one remembers the cry for what Keynes called "euthanasia of the rentier." We have entered the most oppressive rentier epoch since feudal European times. Instead of providing basic infrastructure services at cost or subsidized rates to lower the national cost structure and thus make it more affordable - and internationally competitive - the economy is being turned into a collection of tollbooths. How disheartening that this year's transitory wave of post-Bubble books fails to place the financialization of the

U.S. and global economies in this long-term context.

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